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DOCUMENT: 860-195/006

MEETING OF THE COUNCIL OF PROVINCIAL ENERGY MINISTERS (CPEM)

Energy Security for Canada: The Oil Supply Option

Alberta

August 24 (a.m.), 1987
ST. JOHN'S, Newfoundland

DRAFT

ENERGY SECURITY FOR CANADA: THE OIL SUPPLY OPTION

Alberta Energy
August 18, 1987

Executive Summary

Energy Security for Canada: The Oil Supply Option

Province of Alberta
August 1987

Canada faces increasing dependence on imported crude oil if major new domestic sources of supply are not developed.

Over the past 18 months, Energy Ministers, Premiers and First Ministers have recognized the risks this situation poses for oil supply security and have emphasized the need to develop national solutions.

Canada possesses abundant indigenous oil resources in the offshore and oil sands.

Any significant additions to Canada's light crude supply must come from these areas.

By themselves, the costs of these developments are not insurmountable. And, in contrast to emergency preparedness measures, the social benefits, in terms of employment, balanced regional growth and increased security of supply, outweigh the costs.

Alberta proposes a committed and aggressive policy on the part of governments to get these projects going.

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1. Background to the Current Discussion

- On a per capita basis, Canada uses more energy than any other nation in the world, reflecting both climate and geography.

- Transportation is a critical sector in the Canadian economy, and crude oil accounts for 90 per cent of this sector's energy needs.

- While conservation and efficiency measures will continue to reduce energy demand overall, it is unlikely the oil needs of transportation can be significantly reduced. Future growth in Canadian energy demand therefore will be focused on lighter products.

- At the same time, the Canadian supply of crude is becoming heavier. Even under today's more optimistic price expectations, Alberta production of light conventional crude oil is predicted to drop by more than 300 Mbd by 1995. This is more than total refinery runs in Quebec during 1986.

- In 1986, the Canadian petroleum industry experienced the worst financial downturn in its history as a result of the plummet in crude oil prices. Investment declined and many projects were deferred or shelved.

- In the absence of new domestic supplies of light oil, imported crude will be required in increasing quantities by Canada. The consumers of this oil will be mainly in Atlantic Canada, Quebec and Ontario.

- It is widely acknowledged that, as non-OPEC oil supplies diminish at lower oil prices, OPEC will regain greater control over world prices and crude flows. Experience has shown the cartel is capable of attempting to manipulate the world oil market for political reasons. It also is apt to lose control over individual members, and so disrupt the world market in this way. In any event, increasing import dependance on the part of Canada means increasing vulnerability to disruptions in world supply.

- While this scenario poses risks, it also offers opportunities. Canada possesses abundant indigenous oil resources and is in the unique position of being able to turn a bad situation to its own advantage.

2. Government Responses to the Security of Supply Issue

Recognition of the Problem

- o During the past year, the contribution which the petroleum sector made to Canada's oil supply security has been recognized, as has the need for national measures to help mitigate circumstances that impair the ability of the industry to meet domestic oil needs, both in the near and longer terms.

- o Annual Premiers Conference, August 1986

  The Premiers acknowledged that "The threat to the energy sector is a national problem with a national economic impact and therefore requires a national solution to stabilize the industry's revenues. (The) Premiers urged that a high priority be given to developing strategies which will stimulate Canada's oil and gas activity and ensure that national objectives are met".

- o Canadian Provincial Energy Ministers Meeting, September 1986

  The Ministers unanimously agreed that the situation facing Canada is a national problem requiring a national solution, and that Canada has a unique opportunity to be self sufficient in oil.

  They also recognized that specific measures are required to encourage the development of major new energy supplies in the current unstable and risk averse environment.

- o First Ministers Conference, November 1986

  The Prime Minister concurred that "..energy is a national economic issue (and)...a national challenge." He also noted that security of supply is an important issue requiring a unified approach.

- o October, 1986 - January, 1987

  A task force struck by Alberta, Saskatchewan and Quebec concluded that oil security could be enhanced through a combination of reduced demand for light oil, and increased supply brought on by development of conventional Western sources, offshore and frontier reserves and upgraded oil sands.

  The task force also concluded that, while continued reliance on market forces is desirable, major new light oil projects are inhibited by the current risky price environment, unwilling lenders and investors, the large capital costs involved and long lead time. Under these circumstances, it was recommended that governments assist these new projects, on the condition that the social benefits exceed the social costs of doing so.

Providing Immediate Assistance

- Both Alberta and the Government of Canada have taken steps during the past 18 months to assist the oil and gas industry and help maintain the level of domestic supplies.

April 1986

- The federal government announces a Petroleum and Gas Revenue Tax relief package.
- Alberta announces the Exploratory Drilling Assistance Program.
- Alberta provides $85 million toward the cost of Syncrude engineering.
- Alberta reduces Suncor royalties.

June 1986

- Alberta announces drilling, well servicing and geophysical assistance programs.

September 1986

- The federal government announces elimination of PGRT.

October 1986

- Alberta announces royalty rate reductions and royalty holidays.

December 1986

- Alberta provides a $200 million loan backstop to Syncrude.

March 1987

- The federal government announces the Canadian Exploration and Development Incentive Program.

Establishing a Framework for Long-Term Policy

- In addition to taking interim measures to help maintain the viability of existing oil supply projects, governments have worked toward setting a framework to guide longer-term policies aimed at enhancing oil security.

- In January 1987, the Energy Ministers met to discuss the prospects for energy security. As background to the Alberta/Quebec/Saskatchewan task force report, Security of Supply: An Opportunity for Canadians, Alberta tabled the results of an extensive study commissioned from Informetrica Ltd. This study simulated the possible impact on the Canadian economy of proceeding with early investment in a series of energy projects to produce light and synthetic crude oil.

- This Informetrica analysis revealed that the Canadian economy stands to benefit from the large infusion of investment which these projects would entail and that the gains are not restricted to those areas where the primary investment takes place. All parts of Canada benefit because of the sizeable spin-offs, and many of these accrue to the manufacturing industries of central Canada.

- In addition, the study showed that Canada is better off as a result of these investments even if some public sector support is needed to cover the full supply costs for the projects at very low oil prices. The initial investments, the continuing economic activity associated with producing crude oil and the resulting reduction in imports of crude and products together generate a powerful stimulus to the Canadian economy.

- The Energy Ministers agreed at this conference that continued efforts are needed to maintain the progress toward energy security and to this end, a task force was struck to examine the issues more closely. In subsequent months, governments produced papers dealing with energy security matters.

- The paper released by the federal government in late June--Energy Security in Canada--was among these. In this document, the focus was primarily on emergency preparedness as the appropriate government role for the long term. This approach ignores the natural advantages Canada possesses in its domestic oil reserves, as well as the net social benefits to be gained from developing major new sources of light crude, as indicated by the Informetrica study.

3. Today's Environment

- In considering future action for oil supply development, what are the relevant factors? In Alberta's view, while governments have indicated their willingness to pursue security of oil supply, the obstacles to developments that could make a significant contribution toward achieving this goal are still large.

- In terms of pricing, world prices generally have exceeded expectations during 1987, both in terms of their level and stability. However, the situation remains uncertain and volatile, and so long as this is the case companies will be reluctant to invest large sums. Moreover, their ability to invest in large projects is restricted by the stringent lending conditions adopted by the banks in the wake of the price collapse, and the preference on the part of investors for conventional projects with quick payback.

- To some extent, the impact of the drop in prices has been countered by significant reductions in industry costs. In combination with better prices this year and the fiscal and royalty adjustments that were made previously, project economics on the conventional side have become attractive.

- While the resulting increase in activity in the conventional industry will continue to contribute to Canada's oil balance, the fact remains that significant additions to Canada's light crude oil production must come from major new projects in the frontiers and oil sands. The obstacles that confront the development of these resources still are large. These projects are much bigger than conventional ones, they are capital intensive, have a long lead time, are difficult to finance and, in some cases, face significant environmental constraints. The improvements seen in prices this year have not been sufficient to overcome these major hurdles.

- In addition, by removing earned depletion and adopting a "put-in-use" rule for capital write-offs, the federal government's tax reform package of June 18 has hit hard the economics of projects such as Hibernia and the oil sands.

- In the tax document and EMR's Security of Supply discussion paper, the federal government also published some broad principles under which it would consider assisting projects.

The tax paper emphasized the desire for "non-tax assistance", the need for projects to provide "important regional or national benefits" and be "fundamentally economic". The federal government's security of supply paper mentioned a case-by-case approach to projects that are backed by "significant" private sector equity, are able to produce and market oil or gas at "reasonable cost", allow for a "fair and equitable" sharing of the risks and rewards between the public and private sectors and provide the federal government with an "acceptable return" on its investment.

- These statements of "principles" have compounded the uncertainty facing these projects. It is not clear what is meant by the criteria the federal government has chosen. Are projects to be judged "fundamentally economic" in terms of their social or commercial returns? How do regional economic aspirations fit into this set of criteria? Do "national benefits" include enhanced supply security?

- There would appear to be a number of possible projects that would meet the federal government's conditions, at least by Alberta's interpretation. Development in the east coast offshore, for example, would provide a major boost to the Atlantic region, including direct and indirect employment, opportunities for economic diversification and an expanded tax base.

- By the same token, the Beaufort offers an excellent geological potential and the possibility that early commercial development of the larger fields would inspire the development of other, smaller discoveries.

- The upgraded oil sands resource of western Canada already makes a sizeable contribution to Canada's light oil needs. The prospects for developing this resource revolve around upgrading, where investments in new technologies and design could help make Canada a leader in the field. Diversification and regional aspirations for economic growth would also be met by encouraging companies to maximize the value-added in Canada from the production of heavy oil and oil sands resources.

- In all these cases, there is the potential to both enhance and diversify regional and national economies and promote technological development, while at the same time reducing the potential magnitude of future oil supply risks to the country.

- An examination of the social supply costs for these projects indicates that many of them are economic. These costs are presented in Figure 1 for a number of alternative projects in different regions of Canada. The social supply cost has been calculated as the real oil price needed to cover the costs of developing the project, including a 10 per cent real rate of return to the investor, but excluding royalties or taxes.

The data from the various sources presented here have been normalized to permit comparison of the delivered cost of light crude oil at Montreal in 1986 U.S. dollars.*

- Two important observations can be made about these data. The first concerns the widely varying range in supply cost estimates being promulgated. Of particular concern to Alberta are the estimates for oil sands costs contained in the December National Energy Board report, the December Husky submission to Parliament and the EMR security of supply study. We believe these estimates are out of date. In March of this year, Alberta Energy approached the Alberta Chamber of Resources for their latest estimates for the costs of oil sands development. The chamber has released their study which shows significantly lower costs than widely- quoted sources. It is very important that Canadian governments, industry and the international financial community have up-to-date information about the cost of developing the next increment of Canada's oil supply. Given what the chamber's work reveals, Alberta would suggest the cost estimates for other sources may be less than current conventional wisdom indicates.

  The second point to note is that, even under these higher cost estimates, at today's prices and with any expectation of real growth, a number of these projects are economically viable.

4. <u>An Agenda for Action</u>

- The objective of ensuring security of supply is both to reduce planning uncertainty over the long term and to minimize the potential consequences of major disruptions in supply in the short term. It therefore is important to continue to pursue measures on the demand side that can help reduce Canada's need for imported crude oil, as well as improve our ability to respond to emergencies. Alberta has participated actively in formulating demand restraint measures; our own program is well advanced.

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*Sources:

Alberta Chamber of Resources, August 1987.
Energy, Mines and Resources, Energy Security in Canada: A Discussion Paper, June 1987.
Husky Oil Ltd., Submission to the House of Commons Standing Committee on Energy, Mines and Resources, December 2, 1986.
National Energy Board, Canadian Energy Supply and Demand 1985-2005, October 1986.

- However, even with continued progress toward reducing demand, it remains true that Canada will face increasing dependence on crude oil imports if new domestic supplies are not developed. Moreover, the regional and national benefits that could be gained by developing projects in the frontiers and oil sands have been demonstrated, as has the economic viability of these projects.

- What is missing is a blueprint for more detailed discussions among governments about participating in the continued development of domestic supplies.

- Both the provincial and federal governments have acknowledged during the past year that, in order to assist in developing major new oil supplies, the risks and constraints faced by large, capital-intensive projects in the prevailing investment climate must be reduced.

- Alberta has been approached by several companies interested in pursuing new developments. Their recent analysis of the economics has encouraged them to commence negotiations with governments. But this is a fragile state of interest that could be shattered by an indifferent response. Some companies think the price risk is too high; others are unable to obtain commercial financing for such large ventures. There is a role for governments to play in alleviating these risks and difficulties. Governments have a responsibility to take into account the social costs and benefits resulting from the development of such projects.

- Accordingly, Alberta would like to propose a starting point for an aggressive pursuit of potential oil supply projects on a case-by-case basis. Alberta, for its part, is willing to commence discussions on this basis immediately for a number of in situ, oil sands mining and upgrader projects.

- This is our starting point:

  1. Long-term large capital plans and decisions are not made on short-term price signals. They are the result of a complex interplay of corporate, financial and political factors. While deregulation provides a positive environment for long-term planning, it cannot be relied on to result in private decisions that are in the best interests of Canada when looking at major projects with seven-year planning and construction periods and 25-year operating lives.

2. Projects will be considered in terms of the net social benefits they would confer to a region and the nation.

3. Both the costs and benefits of developments will be shared by governments. This includes, in our view, governments of consuming provinces having the opportunity to invest directly in major supply projects.

4. Assistance will be geared toward overcoming initial constraints to development proceeding, rather than being a permanent form of support. As conditions improve, governments will either be able to phase out their assistance, and/or receive a return on their initial support.

5 To accommodate federal objectives regarding corporate tax reform, assistance will be outside the corporate income tax system.

6. Any measures adopted must be consistent with Canada's obligations under any free trade arrangements.

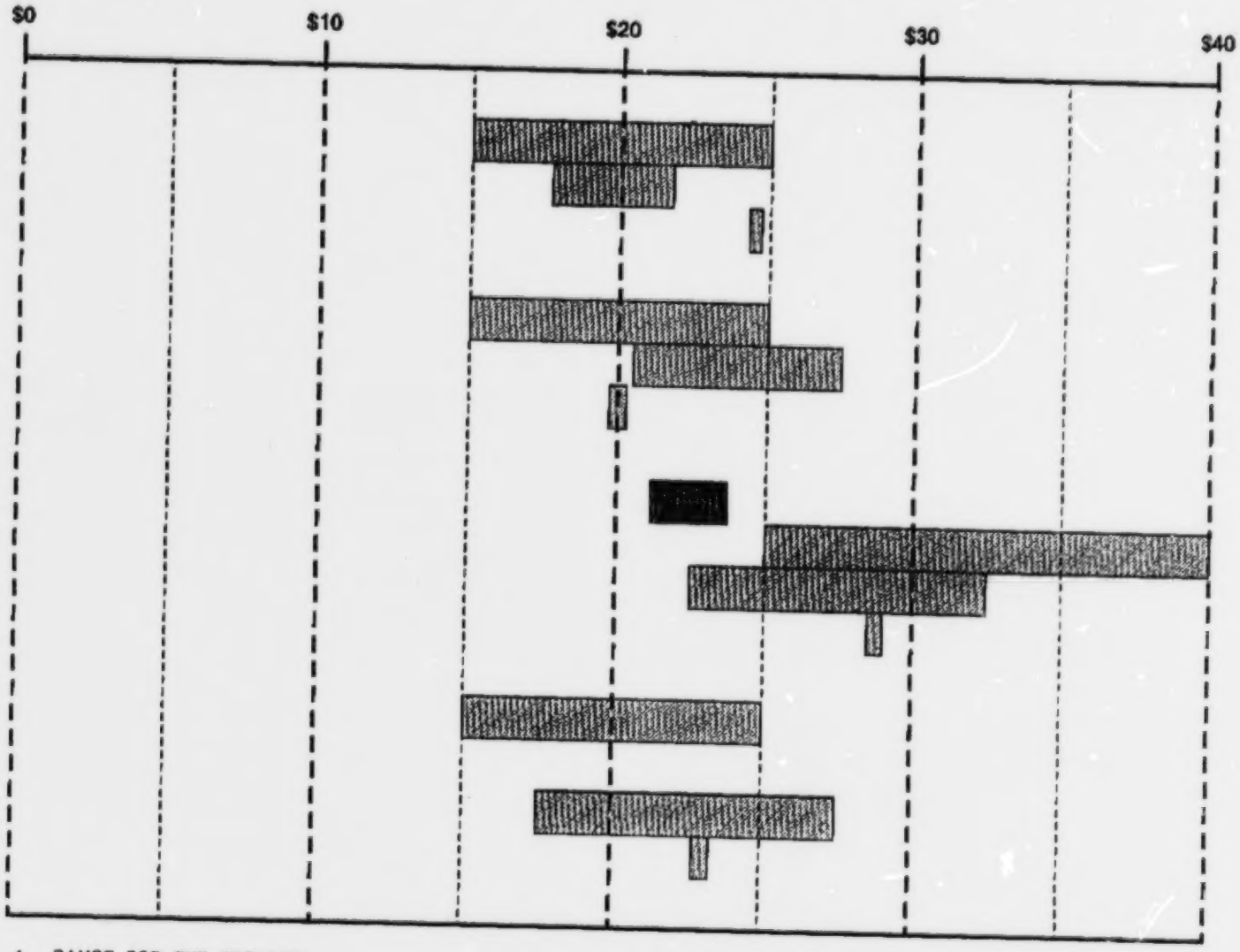
- Alberta is prepared to discuss specific projects with the federal government and other provinces on the basis of these guidelines.

As we have all agreed several times over, the opportunity for Canada is great - let's get on with making it happen!

Figure 1

COMPARISON OF LIGHT CRUDE OIL SUPPLY COSTS

1986 $U.S./BBL IN MONTREAL



1. RANGE FOR THE FRONTIER.
2. SUPPLY COSTS ARE ADJUSTED TO REFLECT MORE RECENT INFORMATION ON NORTHERN PIPELINE TOLLS.
3. POTENTIAL FOR FURTHER COST REDUCTIONS EXIST. LOWER END IS ACHIEVABLE WITH CURRENT TECHNOLOGY.

AUG 18 '87 13:25 FROM AB ENERGY DEP MIN PAGE.013